



Moody's Investors Service

**Statement to the United States House of Representatives
Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises**

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Good morning Chairman Baker, Congressman Kanjorski, and members of the Subcommittee. My name is Ray McDaniel, and I am the President of Moody's Investors Service, which is one of the leading global credit rating agencies. On behalf of my colleagues, let me begin by thanking the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises for the opportunity to participate in today's panel on the state of transparency and competition in the rating agency industry. Before I comment on several of the more specific themes and issues that I expect you will want this panel to consider today, I wanted briefly to offer a more generalized perspective.

Over the past two years there have unfortunately been a large number of companies that have experienced financial difficulties, causing suffering for their employees and sometimes significant losses for the investors in their stocks and bonds. I believe everyone agrees that attempting to understand and, where appropriate, redress the underlying reasons associated with these failings has been both necessary and beneficial. Yet, it is also important to keep in mind that the economy and financial markets of the United States remain the envy of most of the world. Moody's is proud of our role as a supporting player in these markets. Credit ratings help level the playing field for information between borrowers and investors. This function improves both transparency and efficiency in debt markets by promoting investor confidence, which in turn allows creditworthy borrowers greater access to capital.

As you know, throughout the past year the Securities and Exchange Commission and both branches of the U.S. Congress have carried out a series of investigations and fact-finding

studies on the various participants in the U.S. market. Among these participants have been the rating agencies. In hearings conducted last November by the Commission, it repeatedly heard that, overall, the rating agencies have adequately fulfilled their role;¹ that, although there is always room for improvement, the system in general is not broken.

With that perspective in mind, I'd like now to offer a few more in-depth comments about our industry in general, and Moody's policies and practices in particular. Moody's is the oldest credit rating agency in the world, having been founded at the beginning of the last century. From the start, Moody's has focused on rating debt instruments. Our long-term debt rating system for public bonds is the heart of our business. We have 21 long-term debt rating categories, which provide a relative measure of risk, with the probability of default increasing with each step down our rating scale. Our ratings are reliable predictors of relative creditworthiness. Their predictive content has been demonstrated and consistently confirmed through Moody's publication of annual corporate bond default studies,² and by third party academic analysis. As forward-looking opinions, our ratings have effectively distinguished bonds with higher credit risk from bonds with lower credit risk. Moody's long history of success in the credit ratings business demonstrates both the effective disclosure regime in the U.S. securities market and the methodology employed by our analysts.

At Moody's, we are committed to providing the highest quality credit assessments available in the global markets. For 100 years our culture has been based on a commitment to continuous learning, both from our successes and our mistakes. In this spirit, and in line with our statement before the U.S. Senate Committee on Governmental Affairs,³ we have undertaken

¹ See, e.g., Report on the Role and Function of Credit Rating Agencies in the operation of the Securities Markets, U.S. Securities and Exchange Commission, January 2003, at 21 ("In selecting which rating agencies to use, issuers seek those capable of a competent, rigorous analysis that is recognized by the market place. As a practical matter, these have tended to be one or more of the NRSROs.")

This sentiment has also been expressed by the Staff of the Senate Governmental Affairs Committee in a recent report: "If history is a guide, credit rating agencies generally get it right." *Financial Oversight of Enron: The SEC and the Private Sector Watchdogs*, Report of the Staff to the Senate Committee on Governmental Affairs, at 99 (Oct. 8, 2002).

² We are including, as Exhibit A, a copy of our latest default study, published in February 2003, which provides a look at default rates from 1920 through 2002.

³ See Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002). These initiatives include: an enhanced training program for our analysts; the hiring of specialist that provide more in-depth expertise in the areas of accounting, corporate governance, off balance-sheet risk transference. We have already begun to see the impact on our analysis

substantial internal initiatives to learn from recent difficulties in the credit markets, as well as in response to potential shortcomings in our own analytical approach and in the broader system of market checks and balances.

Our business model is based primarily on receipt of fees from debt issuers. Issuers are the natural source of rating agency fees for several related reasons, but most importantly for one key attribute demanded of our ratings: that they be freely and widely disseminated to the investing public. Ratings from the major rating agencies play an integral role in the securities markets not only because they condense and transmit a great deal of credit information about issuers, but because they do so for the equal benefit of *all* investors, and not just a select group of subscribers. Ratings offered in this manner are a public good. Today, the market and regulatory authorities *expect* that ratings on issuers and instruments of publicly offered debt be disseminated *publicly* and *promptly*.

As a rating agency, however, it is also our obligation to manage and protect against the latent conflicts of interest that our business model creates. Moody's has taken strict measures on both an institutional level and on a ratings-practice level. As a corporation, for example, Moody's does not offer investment products, nor do we buy, sell, or recommend securities. Moody's also does not invest in securities for its own account.⁴ Within our ratings practice, committees rather than individual analysts assign Moody's ratings. Analysts are neither compensated based upon the revenues associated with the companies that they analyze, nor are they permitted to hold or trade the securities in their areas of primary analytical responsibility.

Over time, use of our ratings has been adopted by numerous capital market participants for multiple and sometimes conflicting objectives. For example, issuers use our ratings because many investors demand ratings on debt issues. Not surprisingly, issuers would like the highest possible, plausible ratings and greater control over the rating process. Large institutional investors often use our ratings in their portfolio composition and governance guidelines.

because of these various initiatives, and hope to continue improving the quality of our analysis and the reliability of our credit ratings.

⁴ Moody's ultimate parent company, Moody's Corporation, has a publicly disclosed stock repurchase program for Moody's Corporation's New York Stock Exchange listed equity (NYSE: MCO). Moody's Corporation may also, from time to time, invest in short-term securities for Treasury management purposes.

Generally, these investors prefer stability in the ratings on securities that they own.⁵ Finally, global governmental authorities have incorporated ratings into banking, insurance, securities and other regulations to limit risk in financial institutions for the dual purposes of promoting investor protection and improving financial market stability. Because each group has different objectives in using ratings, the performance or “quality” of ratings has also been subjected to multiple assessment processes, which in some cases are incompatible with Moody’s stated purpose of our ratings: that is, to help level the playing field for information between issuers and investors.

Another issue that has been raised frequently in examining rating agencies is the degree of competition within the industry. Moody’s observes that we have been successful over time and around the world in serving markets with different and changing competitive structures. We are confident of our ability to continue to do so, *if* competing successfully is driven by who offers the most reliably predictive credit opinions. That form of competition requires diverse, independent opinions – as opposed to a diversity of firms offering the same opinion, or a diversity of firms whose opinions are all accorded equal authority for reasons unrelated to predictive content. As a key industry participant, therefore, Moody’s does not oppose alternative industry structures; we do, however, urge that any framework not inadvertently encourage competition based on reduced standards.

The role of a rating agency is inherently controversial. It is a rating agency's task to publish opinions regarding the most powerful and influential entities in the financial markets, including governments. We would, therefore, suggest that in examining ratings “quality” and rating agency performance, two essential principles be kept in mind:

- *First*, ratings at their core must be independently formed opinions. To have continuing public value, they must capably predict bond issuers’ future creditworthiness, which means that the agencies must be motivated to act independently of each other, of governments, and of issuers and their agents to reach the highest standards, not the most popular or most convenient standards; and,

⁵ Portfolio guidelines as adopted by many institutions can cause investors to sell securities, sometimes into unfavorable market conditions. As a result, portfolio managers desire stability in ratings to avoid potential trading losses from rule-based trading actions.

- *Second*, rating agencies must disseminate ratings broadly and promptly to all of the investing public. Without this attribute, ratings would cease to be a public good. They would become a tool for users with the greatest financial capacity, and would further tilt, rather than level, the playing field for information.

Only with these principles preserved can ratings continue to fulfill the larger public values of transparency and investor protection that the marketplace, regulatory authorities, and lawmakers expect of us.

Moody's greatly appreciates the Subcommittee's invitation to participate in this important panel discussion. The obligation to assure that the U.S. financial markets remain the fairest and most transparent in the world is one that all market participants share, especially those of us who have been entrusted with that direct responsibility. I look forward to answering any questions the Subcommittee has in pursuit of this important goal.

Thank you.